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Estate Planning Technique*

Thomas N. Tarleau†

Under the catch-all title of "Estate Planning Technique" one might discuss insurance, the law of trusts, the problem of community versus separate property, the law of wills, the problem of domicile, and the law of real property. Be that as it may, this article is confined to a discussion of estate planning technique in the light of the impact of the federal estate tax. The purpose here shall be to compare some of the estate tax problems arising in common law states with those encountered in community property states.

By way of introduction, a passing reference to the obvious seems warranted. Estate tax saving should always be subordinate to the client's wishes as to the disposition of his property. It is pointless to try to convince a man that there are tax advantages in gift-giving if he has economic or family reasons for keeping his property to himself. Of course, estate tax saving becomes a more important ingredient of an estate plan as the size of the estate increases. And finally—and most obvious—since there are no fixed facts and many complex laws, there are no fixed rules of estate planning.¹

Consideration will be given to only three areas: (1) the estate tax on the spouses, (2) skipping estate taxes on subsequent generations and (3) taxation of inter vivos gifts.

I. THE ESTATE TAX ON THE SPOUSES

A. *Prior to the Revenue Act of 1948*

The estate tax on the first spouse to die involves a consideration of the Revenue Act of 1948. What the estate tax lacks in logic, it makes up for in pages of history. The Revenue Act of

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1. Two recommended works are: Trachtman, *Estate Planning* (1951) and Shattuck, *An Estate Planner's Handbook* (1948).

1948, which introduced the concepts of income-splitting, and estate and gift-splitting, was an answer to tax discrimination between citizens of community property states and common law states. The income tax discrimination had been crystallized over twenty years ago in *Poe v. Seaborn*.² During the 1932-1942 period the Treasury sought to end income-splitting in community property states alone by pressing for legislation making a joint return mandatory.³ The Treasury was unsuccessful and the cost to community property states of maintaining their income tax advantage was the loss of their estate tax advantages. Under the 1942 Revenue Act, the entire community property was taxed in the estate of the husband except such part as could be traced to the wife's separate property, to her compensation for her services, or to property derived originally from such compensation. Although the 1942 act introduced the concept of economic, rather than legal ownership, it retained—somewhat inconsistently—the concept of legal ownership to the extent that the wife, if she predeceased her husband, was taxed on her half of the community. The 1942 legislation was upheld in the Supreme Court.⁴

Let us pause here to consider, in a very general way, the estate planning of the 1942-1948 period, using as our assumption that the husband owns all the property or that all the community property was acquired through his efforts. The primary tool in common law states was the life estate to the wife, remainder to the children. If H died first, this disposition would result in one estate tax on all of H's property, but no estate tax on the death of W. If W died first, she would, of course, have no estate to be taxed and the estate tax would still fall on H's entire estate. In community property states this disposition was very satisfactory only if W died first. Thus, if W's will gave H a life estate⁵ in her legal one-half of the community, remainder over to children, W would be taxed on her legal one-half and H on his subsequent death would only be taxed on his legal one-half. However, if H died first, he could only dispose of one-half, since his wife was entitled to a fee interest in the other half. Thus, even if he

2. 282 U.S. 101 (1930).

3. Reihm, *The Impact of Community Property Law on Federal Taxation*, 4 *Southwestern L.J.* 161, 172-175 (1950).

4. *Fernandez v. Wiener*, 326 U.S. 340 (1945).

5. Wherever reference is made to a division of property into life estate and remainder, it is intended to refer to the local law equivalent. For a discussion of usufruct—naked ownership equivalent in Louisiana, see Wisdom and Pigman, *Testamentary Dispositions in Louisiana Estate Planning*, 1951 *Tulane Tax Institute*.

gave her a life estate in his half, remainder over to children, he would be taxed on the entire estate as economic owner thereof, and she would, on her death, be taxed on her half. The community property states were, quite understandably, dissatisfied with this estate tax disadvantage. The common law states, with even greater cause for displeasure, chafed under their continuing income tax disadvantage. These sources of irritation, as well as others, finally penetrated the shell of the Congress and produced the provisions of the Revenue Act of 1948, truly cultivated pearls.⁶ And like all pearls, the question for the stylish estate planner is how to wear them.

B. Under the Revenue Act of 1948

1. *Comparison Between Systems of Property Law.* The Revenue Act of 1948 gave the common law states their income-splitting, and averted further secession from the common law column.⁷ The 1948 act also repealed the 1942 estate tax legislation which had been so distasteful to the community property states. In its place, the 1948 act gave the common law states the privilege of estate-splitting. This it accomplished through the concept of the marital deduction for property passing to the surviving spouse.⁸ In the effort to create equality of treatment between the community property state and the common law state, Congress provided in effect that only a fee interest or its practical equivalent would qualify for the marital deduction.⁹ It further provided that the marital deduction would be limited to one-half of the "adjusted gross estate."¹⁰ The concept of an

6. See Surrey, *Federal Taxation of the Family—The Revenue Act of 1948*, 61 Harv. L. Rev. 1097, 1117 (1948).

7. The original roster of community property states was Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington. Oklahoma (1945), Oregon (1947), Michigan (1947), Nebraska (1947), Hawaii (1947) adopted the community property system prior to the Revenue Act of 1948. Pennsylvania tried to adopt the system but the legislative effort was declared unconstitutional by the Pennsylvania court. Various states (Indiana and Massachusetts) were considering adoption of the system. Shortly after enactment of the Revenue Act of 1948, Oklahoma, Oregon and Michigan discarded their community property laws.

8. Int. Rev. Code § 812(e).

9. Int. Rev. Code § 812(e)(1)(B) provides that no deduction shall be allowed for a "terminable interest" (such as a life estate or an estate during widowhood) provided (1) that an interest in the same property (such as the remainder) passes from the decedent to a person other than the surviving spouse, (2) that such interest passes or has passed for less than an "adequate and full consideration in money or money's worth," and (3) that such interest may be possessed or enjoyed by such other person (or his heirs or assigns) after the termination of the interest of the surviving spouse. The provisos are important and U.S. Treas. Regs. 105, § 81.47a-(b) gives examples of some "terminable interests" that do qualify for the marital deduction.

10. Int. Rev. Code § 812(e)(1)(H).

"adjusted gross estate" was introduced merely to assist in defining the maximum marital deduction. In computing the adjusted gross estate, the decedent's one-half of the community property was to be excluded.¹¹ In other words, the community property was to be excluded in computing the maximum marital deduction. Thus, speaking generally, a husband in a common law state worth \$100,000 could, at his election, will¹² at least \$50,000 to his wife and thus procure a marital deduction limited to \$50,000. A husband in a community property state, assuming the community property consists of \$100,000, would automatically get the split-estate advantage since on his death the wife could normally get her one-half interest under the local law. He could not get a marital deduction as to the \$50,000 included in his estate. There is an obvious tax advantage where the husband's estate is split so that, as in the illustrations, two estates are created upon which no tax is payable by virtue of the \$60,000 estate tax exemption. So also, because of progressively increasing rates, tax savings exist where the tax on the two estates would be less than the tax on the husband's estate alone.¹³ From these illustrations, it is clear that the fundamental difference in the estate planning techniques of the common law planner and his community property brother is the fact that marital deduction is voluntary and elective, whereas the operation of local law on community property is not.

Compare the situation of Mr. Common who has a substantial estate and a penniless wife and Mr. Community who has no separate estate, an interest in substantial community property, and a wife who has no separate property of her own. As to Mr. Community and his wife, nothing need be done about the splitting of the community property: it is split automatically. Estate planning for Mr. and Mrs. Community will largely entail

11. Int. Rev. Code § 812(e)(2)(B).

12. In order to obtain the marital deduction it is not necessary that the property qualifying for the deduction be willed to the surviving spouse. In order to obtain the deduction it is sufficient if the property "passes" to the surviving spouse. Property "passes" under Int. Rev. Code § 812(e)(3) by bequest or devise, by intestacy, by election to take statutory interest rather than under the will, by right of survivorship as joint owner, etc.

13. The estate tax rates are not constantly progressive. Thus, the following statement from Trachtman, *Estate Planning*, 27 (1951): "And it should not be concluded that the marital deduction in the first estate will always increase the aggregate Federal taxes on both estates, merely because the surviving spouse's estate is substantial. If the estate of the spouse who dies first is approximately \$200,000, the surviving spouse's estate may be as much as \$300,000 without running into any increased Federal estate tax as a result of taking the maximum marital deduction in the first estate."

dispositions designed to skip estate tax on subsequent generations.¹⁴ As to Mr. Common, he has an election to forego the marital deduction or to seek the benefit of less than the maximum marital deduction. His reasons for not seeking a marital deduction could be such non-tax considerations as a desire to cut the surviving wife off immediately upon her remarriage or a distrust of the surviving wife's ability to dispose of the property at her death. If he will not give his widow the practical equivalent of a fee in any of his property, his estate can not claim a marital deduction. A decision not to claim the maximum marital deduction could be based upon a desire to leave the widow only such amount as would prevent her election to take against the will or a disinclination to give a business interest to a wife. In addition to these problems of whether or not to take the marital deduction and whether or not to take the maximum, counsel for Mr. Common has the difficult problem of the method of obtaining the marital deduction. In the short space of this article, one cannot explore the various intricate methods of obtaining this deduction and testamentary clause techniques. However, it is suggested that in common law states a frequent technique is to create a so-called marital deduction trust, in other words, a trust comprising one-half of the adjusted gross estate, consisting of assets that qualify for the marital deduction under the Internal Revenue Code, and providing that the surviving spouse has a life interest in the income and a general power of appointment over the remainder.¹⁵

Let us next consider the estate tax problems of Mr. Common, whose property is valued at \$500,000, and Mrs. Common owning property of \$200,000. Contrast this couple with Mr. and Mrs. Community who own \$500,000 in community; in addition, Mrs.

14. See Nossaman, *New Regulations on Community Property*, 88 *Trusts and Estates* 344 (1949) and Nossaman, *The Impact of Estate and Gifts Taxes Upon the Disposition of Community Property*, 38 *Calif. L. Rev.* 71, 74 (1950) for a discussion of a testamentary disposition under which H puts the entire community in trust, income to W for life, remainder to children, and W elects to take under the will rather than claim her one-half interest outright. Will W be subject to estate tax under Int. Rev. Code § 811(c) on her one-half of the trust corpus since by her election she has retained a life interest in that property? Will a gift tax be imposed on the value of one-half of the remainder as a result of W's election? Mr. Nossaman submits that these questions have not as yet been answered by the courts. The curious aspect of this disposition is that H succeeds in splitting the community for tax purposes whereas a husband in a common law jurisdiction can not resort to this means of fixing the rights of his children and still obtain the marital deduction.

15. See Int. Rev. Code § 812(e)(1)(F).

Community owns \$200,000 as her separate property. What are the estate tax objectives on the assumption that the husbands will predecease their wives? The problem of Mr. Common's counsel is, in addition to those heretofore discussed, one of mathematics. His question, if he decides to take the marital deduction and has a method for obtaining it, is how much of a marital deduction is most advantageous tax-wise. If he takes the maximum marital deduction the husband's estate will be \$250,000 and the wife's will be \$450,000. From the purely tax point of view, the planner could take a marital deduction of \$100,000 and thus equalize the two estates. As to Mr. and Mrs. Community, the planner cannot hope to equalize the estate on the death of the husband survived by his wife. Mr. Community's estate is automatically \$250,000 and the wife will have an estate of \$450,000. This would appear to be a discrimination against Mr. Community. But now consider the same facts on the assumption that the wives will die first. The common law planner will not seek to obtain the marital deduction in the wife's estate. If he were to do that Mrs. Common would be taxed on \$100,000, and her husband would be taxed on \$600,000, that is, the wife's marital deduction would be pyramided in the husband's estate at his higher bracket. As it stands, the wife would therefore be taxed on her \$200,000 and the husband would be taxed on his \$500,000. The community property couple fare better, assuming that the wife can take the maximum marital deduction as to her separate property.¹⁶ Her estate would therefore be one-half of the community property (\$250,000) and one-half of her separate property (\$100,000), or \$350,000. The husband on his subsequent death would have an estate of \$350,000 as well. It is clear from this illustration that, unlike the common law planner who must always wrestle with the "why" and "how" and "how much" of the marital deduction, the planner in a community property state must tackle these problems only when one of the spouses has separate property.¹⁷

16. For a discussion of the Louisiana system of forced heirship, i.e., the entitlement of descendants and parents to the decedent's property, and its effect on the maximum marital deduction, see Wisdom and Pigman, *op. cit.* supra note 5, 245-247.

17. It is necessary for the decedent-spouse to have separate property in order for the marital deduction to apply. However, it is not necessary that the separate property itself pass to the surviving spouse. The transfer of community property to the surviving spouse—once it has been determined that the decedent can obtain a marital deduction because of the existence of separate property—will qualify. As to the gift tax, however, the marital deduction does not apply to a gift of community property. See Appleman, *How Gifts and Estates Are Taxed in Community Property States*, in *The Estate Tax Handbook* 315, 334 (Lasser ed. 1951).

But the very words "separate property" are a problem in themselves for community property estate planners.

2. *The Problem of Separate Property.* While it is true that community property problems arise occasionally in common law states, the problem of "separate property" in community property states is constantly recurring. Of course the status of property as "separate property" is primarily a problem of the local community property law. But the Internal Revenue Code prescribes, in some measure, its own definition of "separate property." Where community property was converted into separate parts after the enactment of the Revenue Act of 1948, such separate property is considered community property for the purpose of computing the maximum marital deduction.¹⁸ In other words, if the decedent's estate consisted only of an interest in community property and such converted property (separate property for local law purposes), there would be no marital deduction. The reason for denying the marital deduction for such property is made evident by an illustration. If community property of \$200,000 is converted into separate property of H and W after April 2, 1948,¹⁹ there is no gift tax. On the death of H, if the marital deduction applied to his \$100,000, H would succeed in passing another \$50,000 to W free of any transfer tax. By denying the marital deduction to such separate property, the objective of permitting only 50% of the property to pass free of tax is maintained. Since the Treasury took the position that conversions during the 1942-1948 period were subject to gift tax, a marital deduction is available as to such separate property. The rule that certain separate property shall be considered community property for the purpose of computing the maximum marital deduction applies to community property which was converted during 1942. The rationale here again is the absence of a gift tax on such conversions. This policy should have equal application to pre-1942 conversions. However, because of tracing difficulties, the rule does not apply to such pre-1942 conversions. The rules for computation of the adjusted gross estate in community property states and the special rule for California com-

18. Int. Rev. Code § 812(e)(2)(C).

19. Community property which was converted to separate property during the period 1942 to April 2, 1948 (the date of enactment of the Revenue Act of 1948) retains its status as separate property for tax purposes. The Treasury takes the position that a gift tax was payable on conversion during that period.

munity property are set forth in the Regulations.²⁰ The repeal of the distasteful 1942 legislation did not, therefore, eliminate entirely the difficult problems of segregating separate property from community property.²¹

3. *New Basis Provisions for Community Property States.* One further change in the 1948 act is of particular interest to the estate planner. The basis of property acquired by inheritance is the fair market value at the date of death.²² In a common law state, the husband's low basis property could at his death take the higher date-of-death valuation as its tax basis without an income tax on the appreciation. In the inflationary period of the last decade, this stepped-up basis was, and still is, advantageous from a tax point of view. Since planners can only project present facts, they continue to hold low basis property in the estate while making sales of high basis property to obtain income tax losses. Prior to 1942, this present advantage was not available to the same degree in community property states. Community property passing to the surviving spouse by operation of the local law did not take a new basis. The 1948 act, although it restored the pre-1942 law generally in community property states, did modify this rule as to basis of community property. Under the present law, the interest in community property passing to the surviving spouse may take the value at date of death as its new basis.²³ In general, the new law creates equality between citizens of common law and community property states under the more usual circumstance of property owned entirely by the husband who predeceases his penniless wife. However, where the wife predeceases the husband, her death has no effect on the basis of property owned by the common law husband whereas, in most community property states, her death changes the basis of one-half of community property held by, and, it shall be assumed, acquired by the efforts of, the husband. Under present inflationary pressures, the community property husband may be very

20. U.S. Treas. Regs. 105, § 81.47(d). The next-to-last sentence of Int. Rev. Code § 812(e)(2)(B) excepts from the definition of "community property" pre-1927 community property in California. Prior to July 29, 1927, the California wife had an "expectancy" in the community property and thereafter she had an undivided half interest. Commentators in this field make a special point of noting that it is possible that the statutory language of the code is not limited to the pre-1927 California system. For gift tax provisions, see Int. Rev. Code § 1004(a)(3)(F); U.S. Treas. Regs. 108, § 86.16c.

21. See Kelleher, *The Marital Deduction under Louisiana Law 283* (1951 Tulane Tax Institute).

22. Int. Rev. Code § 113(a)(5).

23. *Ibid.*

pleased at this unlooked for tax advantage. But the price for the present edge may come in some future deflationary period when the surviving husband may be dismayed to discover that one-half of the property acquired by him at a high cost takes as its income tax basis the lower value on the death of his community property wife. Presumably this new basis provision will have its effect on estate planning for community property both as regards conversion of separate property into community property and as to any program of inter vivos gifts.²⁴

4. *Planning for decedent's income.* It sometimes happens that an important asset of a husband's estate is compensation earned during life by the husband and paid by his employer after the husband's death. Consider, for example, the fees which lawyers and accountants earn but which remain unpaid at death. These amounts may be received shortly after death and, if they are sizeable, they may be subject to high income taxes. It is conceivable that the estate planner intent on computations of estate tax may overlook opportunities for tax savings on this post-death income.

Income such as the items heretofore described is taxed under Section 126 of the code. That section provides that "items of gross income in respect of a decedent which are not properly includible" in the final or any prior return of the decedent shall be taxed in the year received to the decedent's estate or beneficiary actually receiving such amount. Section 126(a) (3) further provides that this "income in respect of a decedent" shall have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount. In a community property state it would seem that such Section 126 income is automatically split between the surviving wife and her husband's estate.²⁵ Such post-death income splitting is denied to the common law couple.²⁶

The prospective decedent in a common law state cannot rely

24. See Flint, *Estate Analysis in Community Property States*, 86 *Trusts and Estates* 473 (1948) for a comparison of the advantages of community property over separate property with emphasis on the apportionment of probate costs.

25. See I.T. 3931, 1948-2 C.B. 87. Note that the problem of the wife's ownership of a share in Section 126 income is different from the problem of the divisibility of *all* income between the decedent's estate and the surviving spouse.

26. The last possibility for income-splitting between a common law couple exists relative to the decedent's prior-to-death income tax return. See Int. Rev. Code § 51(b)(4).

on his local law to accomplish any tax savings. As to Mr. Common, he can bequeath the right to receive such income to several beneficiaries. By doing so he reduces the income tax which otherwise would be payable by his estate as the only recipient. Mr. Community can perhaps do likewise as to his half share of the income which will be paid after his death.

Mr. Common has a further problem relative to Section 126 income. Under Section 126 the recipient of "income in respect of a decedent" is entitled to an income tax deduction for estate taxes paid with respect to such income. This income tax deduction is limited to "the estate tax attributable to the net value for estate tax purposes" of such item.²⁷ What happens when the Section 126 income is the property used to qualify for the marital deduction? Will the commissioner contend that no estate tax was paid as to such property and that therefore no estate tax is attributable to such Section 126 income? The question has not as yet been squarely ruled upon.²⁸ The danger of losing this income tax deduction, if it exists, may be avoided by using other property to qualify for the marital deduction.

This problem of the interaction of Section 126 and the marital deduction may exist for the community property estate planner. In most instances, the right to Section 126 income is community property.²⁹ If no separate property exists, there is, of course, no problem of marital deduction. If separate property does exist, the code does not require that the separate property itself pass to the surviving spouse. A transfer of community property—once the marital deduction is obtainable by virtue of the existence of separate property—will qualify for the marital deduction. The estate planner in a community property state should also avoid passing the right to Section 126 income as the property qualifying for the marital deduction.

A recent letter ruling³⁰ seems to indicate that wherever the maximum marital deduction is taken the income tax deduction for Section 126 income is necessarily reduced. Without burdening

27. Int. Rev. Code § 126(c).

28. See Informal Ruling, 52-5 C.C.H. Standard Federal Tax Reporter, Par. 6162 (March 17, 1952).

29. The determination of the Statutes of Section 126 income as community property is, of course, a question of local law. Be that as it may, it would seem that estate planning relative to such income would usually involve compensation, a form of income which enures to the community.

30. See Informal Ruling, 52-5 C.C.H. Standard Federal Tax Reporter, Par. 6162 (March 17, 1952).

the reader with various computations, it is submitted that in planning estates where large amounts of Section 126 income are involved, consideration should be given to increasing the income tax deduction by decreasing the marital deduction.

5. *Summary.* In summary, as to the changes brought about by the Revenue Act of 1948, the orientation in common law states is completely new. Instead of the all-out effort to avoid a "second" tax on the wife by giving her a life estate in all the husband's property, much time, effort and mathematics go into creating the "second" tax in the expectation that the "first" and "second" taxes, by use of the marital deduction, will both combined be less than a "first" tax on the husband alone. In the community property states the pre-1948 headache of "tracing" the source of the community property has been replaced with the problem of segregating separate property from community property under federal definitions of those words. If no separate property is found, the problem of selecting alternatives—the basic questions of whether and how much of a marital deduction to take—is out. If separate property does exist, then the community property planner has the same problems as his fellow aspirin-swallower in a common law state,³¹ including the problem of local law limitations on the amount of disposable property.

II. SKIPPING ESTATE TAXES ON SUBSEQUENT GENERATIONS

Thus far, we have dealt exclusively with the surviving spouse and with, generally speaking, only one-half of the decedent's estate, or to the community property lawyer, the one-half interest of the survivor in the community. What about the other half? We are now faced, again from the exclusively tax viewpoint, with the problem of skipping estate tax on subsequent beneficiaries. Of course, this problem of skipping estate taxes must always be considered in the light of local law limitations on the amount of the disposable property. An estate tax on the subsequent generation can be avoided by inter vivos transfer from, for example, a grandfather to his grandchild. But it is right in this area that the planner—in both the common law and com-

31. The endeavor of the Revenue Act of 1948 to achieve equality in tax treatment between citizens of common law states and community property states has failed in several aspects. In addition to the fact that, unlike the situation in community property states, estate splitting is not available in common law states where the penniless wife predeceases her rich husband, there are continuing inequalities which are brought out in Surrey, *op. cit.* supra note 6, and De Wind, *The Approaching Crisis in Federal Estate and Gift Taxation*, 38 Calif. L. Rev. 79 (1950).

munity property states—is met with the normal resistance to parting with dominion and control of property during life. The problem therefore becomes one of disposing of property at death in accordance with the testator's desires, within the framework of the local law, and pursuant to a plan that avoids estate tax on subsequent beneficiaries to whatever extent possible. Obviously, one such beneficiary of the other half can be, and frequently is, the surviving spouse.³² Be that as it may, it will be assumed in subsequent illustrations that children and grandchildren are the beneficiaries of the other half.

A standard method for skipping an estate tax is a life estate to the child, remainder to the grandchild.³³ On the death of the child, no estate tax will be imposed. But this desirable tax result has obvious non-tax disadvantages. What if the income interest is inadequate? What if the testator has misgivings as to fixing the rights of an infant grandchild who may prove to be undeserving? Furthermore is it possible to skip the estate tax even on the grandchild? Some of the answers to these questions are found in the Powers of Appointment Act of 1951. And the following short discussion is pertinent to those jurisdictions which recognize the power of appointment.³⁴

A. Powers of Appointment Act of 1951

For purposes of this article, it is unnecessary to develop the historical background of this 1951 legislation.³⁵ If the client is not the donee of a power and has made no previous disposition of his property, the estate planner is free to ignore the varying tax treatment of powers of appointment created before 1942. Consideration will only be given to powers of appointment which may be used at some future time. Under the 1951 legislation a general power of appointment is one which may be exercised in

32. See De Funiak, *Principles of Community Property* § 198 (1943) (in Nevada and New Mexico the wife has no power of testamentary disposition over her half if she predeceases her husband). See Seghers, *Powers of Appointment in Testamentary Trusts*, 30 *Taxes* 679 (1952) for a discussion of the non-marital deduction trust for the widow in common law jurisdictions particularly.

33. Systems of forced heirship in Idaho and Louisiana limit planning for estate tax savings but these barriers do not appear to exist in other community property jurisdictions. See De Funiak, *ibid*.

34. See Wisdom and Pigman, *op. cit. supra* note 5, for a discussion of the illegality of the power of appointment in Louisiana. See Texas L. 1951, S.B. 34; California L. 1945, Ch. 318; Oregon L. 1947, Ch. 91; Hawaii L. 1947, Act 126, dealing with release of powers of appointment.

35. See Craven, *Powers of Appointment, Act of 1951*, 65 *Harv. L. Rev.* 55 (1951).

favor of the donee of the power, his estate, his creditors or the creditors of his estate.³⁶ If the donee of a general power dies, the property which is subject to that power is included in his estate. Thus, if the client creates a testamentary trust giving his child a life estate and a general power to appoint the remainder, the corpus of that trust will be included in the child's estate whether or not he exercises that power. From the tax viewpoint, the child's interest in the property is tantamount to a fee. However, if the client gives his child a life estate and a limited power to appoint the remainder, there is no estate tax on the appointive property at the death of the child. A limited power is any power except a general power. Excluding the child from the power to appoint to himself, his estate, his creditors and his estate's creditors leaves ample room for choice of heirs, such as deserving grandchildren or practically anyone else to whom the child appoints. Clearly, the limited power of appointment is an important tool to the estate planner since it permits skipping estate tax on one generation while permitting, if the father so desires, substantial latitude in the child's selection of the remaindermen. It should also be noted that the child—assumed to be the donee of the power—need not necessarily appoint the property outright to his appointees—assumed to be grandchildren. The child could, through a proper exercise of the power, postpone the impact of the estate tax until the great-grandchildren's generation. He could, if permitted by rule against perpetuities in his particular state, give the grandchildren a life interest with remainder over to the great-grandchildren.

More than likely the testator, the Noah of the above mentioned generations, is too pessimistic about our civilization to worry about skipping estate taxes on the grandchildren. He will probably be quite satisfied with skipping the estate tax on his child's estate and be much more concerned with the fact that his child—the one whom he really desires to benefit—is limited to the enjoyment of a life estate. Here again, particularly in common law jurisdictions, the Powers of Appointment Act benevolently supplies a remedy. The child, in addition to the life estate, could be given the power to withdraw up to \$5000 a year out of the principal of the trust.³⁷ If the child does withdraw

36. Int. Rev. Code § 811(f)(2), (3).

37. Int. Rev. Code § 811(f)(5). The statute is not phrased in terms of withdrawal power. In fact it applies to any lapsed power of appointment with certain limitations.

money and consumes it, the money will not be in his estate at his death. If he does not withdraw, his failure to withdraw his annual \$5000 could, were it not for the 1951 legislation, give rise to both gift and estate taxes on him. Prior to the 1951 law, the Treasury took the position that permitting such a power to lapse was, in effect, a transfer of a remainder interest in the \$5000 with a reservation of life income. Such a transfer, according to the pre-1951 theory, was subject to gift tax on the transfer of the remainder interest and to estate tax on \$5000 since a life income therein was, under the trust, reserved to the child. The 1951 act has changed that result. If the child never exercises his power to withdraw the annual \$5000, there is no annual gift tax and no estate tax on the annual lapses of the power preceding the year of death. In the year of death, only \$5000 is included in the child's estate. For illustration purposes the dollar limitation of \$5000 set forth in the code has been used. In fact, the withdrawal power can be the greater of \$5000 or a percentage of the corpus. Use of the percentage limitation, rather than the straight \$5000 limit, entails certain difficulties which, in practice, inclines a planner to express the withdrawal privilege in the dollar amount.³⁸

In addition to the power to invade corpus, the Code now exempts from estate tax property over which the decedent has a power to withdraw from the principal where the power is limited by an ascertainable standard relating to his health, education, support or maintenance.³⁹ Thus, if the father is concerned about enlarging the enjoyment of his immediate heir, the child, he could give the child such a power and still achieve the objective assumed here, that is, skipping the estate tax on a subsequent generation. If the child never exercised this limited power, there would be absolutely no tax consequences since the power is specifically excluded from the Code definition of a "general power."

Thus far the testamentary aspects of estate planning have been discussed and, summarizing the differences between estate planners under the two systems of property law, one could say that the problem of skipping estate tax on subsequent generations

38. Int. Rev. Code § 811(f)(5)(B) provides that the withdrawal power may be up to 5% of the aggregate value of the corpus at the time of the lapse (non-exercise) of the power. Because of the inability to project the future value of corpus, the \$5000 limitation may be preferable.

39. Int. Rev. Code § 811(f)(3)(A).

is similar (except for local law inhibitions on testamentary disposition) and that the problem of minimizing estate taxes between the spouses is much the same where separate property is held by one of the spouses in a community property state.

III. INTER VIVOS TRANSFERS

Inter vivos transfers can accomplish one of the objectives already discussed, that is, skipping estate tax on subsequent generations. But more than the estate tax advantage is involved. Since the income of transferred property is thereafter taxed for income tax purposes to the transferee, a shift in income tax is, of course, accomplished. Furthermore, since the transfer frequently takes the form of a gift, the gift tax is involved. Inter vivos transfers therefore involve quite frequently a careful computation of the incidence of all three federal taxes.

A. *Advantages of Inter Vivos Gifts*

The advantages of inter vivos gifts are so familiar that only brief reference need be made to them. The pre-1948 income tax advantage of making gifts to a spouse in a common law state no longer exists since the enactment of income-splitting provisions of the Code.⁴⁰ However, the income tax advantages do exist where income-producing property is given to a child whose surtax bracket is substantially lower than his father's. From an estate tax point of view, the estate tax can, of course, be avoided in the child's generation by making the gift to the grandchildren. As between the two spouses, they can avail themselves of a \$60,000 specific exemption⁴¹ and an annual exclusion of \$6000⁴² as applied to gifts of present interests.⁴³ The annual exclusion applies to any number of donees so that a fairly substantial amount of property can be donated annually during life over and above the \$60,000 exemption without imposition of the gift tax. Furthermore, because of the differences in the rate of tax,⁴⁴ transfer by gift can provide tax savings and, obviously, inter vivos gifts come out of the estate of the potential decedent at his top bracket and are taxed at the lower gift tax bracket.⁴⁵ Of course, inter vivos

40. Int. Rev. Code § 12(d).

41. Int. Rev. Code §§ 1004(a)(1) and 1000(f).

42. Int. Rev. Code §§ 1003(b)(3) and 1000(f).

43. Int. Rev. Code § 1003(b)(3).

44. The gift tax rates are 75% of the estate tax rates.

45. The operation of the gift tax is cumulative, see Int. Rev. Code § 1001(a).

transfers lose their tax appeal when the gift tax bracket exceeds the estate tax bracket.

B. *Estate Taxation of Inter Vivos Transfers*

With these highly generalized statements on the advantages of making inter vivos gifts, let us, in an equally general way, review those sections of the Code which tax property which had been transferred inter vivos. If a person makes a transfer reserving a life interest in the property transferred,⁴⁶ if he retains a power to change the beneficial enjoyment of the property transferred,⁴⁷ if he makes a transfer which the Code describes as one intended to take effect at death,⁴⁸ then such property will be included in his estate. Furthermore, if he makes a gift in contemplation of death, such gift will be taxed in his estate unless the gift was made more than three years prior to the date of death.⁴⁹ A transfer made during the three year period is presumed to be made in contemplation of death. To the extent that the three-year period is still a hurdle for estate planners, any material which would rebut the commissioner's contention that the transfer was motivated by the thought of death should be preserved.

C. *Inter Vivos Business Arrangements*

The foregoing comments generally answer the questions as to why to give, how much to give, how to give, and to whom to give. The remaining considerations are what to give and any other arrangements which offer ultimate estate tax advantages.

It frequently happens that the major asset of a client is his stock in his one-man corporation. If there is but one class of stock, he could, of course, make a gift of a minority interest to, for example, his children. The obvious disadvantage to making such a gift is the possible difficulties of selling the majority interest which he retains. Minority interests in a corporation, if hostile, can become a thorn in the side of the donor or of his vendee. The obvious solution to retaining complete control of the corporation is to create some sort of junior security so that the father can retain control through his senior securities and can make gifts of junior securities to the subsequent generations. The inter vivos disposition of these junior securities reduces the do-

46. Int. Rev. Code § 811(c)(1)(B).

47. Int. Rev. Code § 811(d).

48. Int. Rev. Code §§ 811(c)(1)(C) and 811(c)(3).

49. Int. Rev. Code §§ 811(c)(1)(A) and 811(l).

nor's estate and creates possibilities for shifting of income to low bracket donees. Of course, if it is necessary to recapitalize or reorganize the corporation in any way, the income tax consequences of that act should be carefully considered.⁵⁰ In addition to the disposition of junior securities, another type of property should have priority in any plan for lifetime transfers. It is suggested that property of problematical valuation—property which may entail a long drawn out valuation fight on the decedent's death—might well be transferred during his lifetime. It would seem that the owner of such property could be an invaluable witness should his valuation be attacked. Furthermore, a valuation established during life for gift tax purposes, may, in some instances, be persuasive as to the value of similar property retained by the decedent until his death.

In connection with valuation, let us return to the problems of the impact of the estate tax on the decedent's stock in his corporation. This time, consider the case of two stockholders or, alternatively, two partners. What if the major asset in the estate of the decedent is such a 50% interest in a business? What can be done during life to establish a valuation for this business interest? What can be done to prevent the interest from falling into the hands of individuals who may challenge the guidance of the surviving business partner? Will the decedent's heirs be required to liquidate a part of the business interest which they inherit in order to pay the estate taxes and administration expenses?⁵¹ The answer to these questions may be in a binding agreement under which the two partners or two stockholders agree to sell their interest to the survivor at a fixed fair purchase price. Each partner procures insurance on the other's life and the lucky survivor pays the purchase price out of the proceeds of such insurance. Although the Treasury challenged similar arrangements by seeking to tax both the insurance proceeds and the business interest in the estate of the decedent, the Tax Court included in the gross estate only the value of the business interest as fixed by the unconditional obligation to sell at a given price.⁵² The Treasury's acquiescence in the Tax Court decision is significant.⁵³ No further effort to tax both the business inter-

50. Int. Rev. Code & 112(g).

51. In connection with the problem of redemption of stock to pay estate taxes, see Int. Rev. Code § 115(g).

52. Ray E. Tompkins, 13 T.C. 1054 (1949), Acq. 1950-1 C.B. 5; Estate of G. C. Ealy, 10 T.C.M. 431 (1951).

53. Ray E. Tompkins, 13 T.C. 1054, Acq. 1950-1 C.B. 5.

est and the insurance proceeds on the ground that the decedent indirectly paid the premiums is anticipated. However, tax aspects of plans other than the cross-insurance pattern should be closely scrutinized.

In addition to the buy-and-sell agreement, a binding option, even though unilateral, will establish the value of decedent's business interest where the parties are dealing at arms' length,⁵⁴ where the option fixes a purchase price which is deemed adequate as of the time the option is granted,⁵⁵ and where the decedent could not have disposed of the optioned property prior to his death.⁵⁶ Of course, reciprocal options between stockholders or partners have, under the same conditions, established date-of-death value.⁵⁷

IV. CONCLUSION

Conclusions have been summarized at various points in this article. Once again, it is conceded that a general survey fails to take into account the many local laws dealing with the power of testamentary disposition, the use of the trust device, the rule against perpetuities and the power of appointment. And again it is urged that estate planning technique should involve much more than estate tax savings.

Finally, one further thought warrants expression. The discussion herein has been premised on the existence of a substantial estate. But the existence of such an estate is, in turn, based upon the ability to accumulate property. And the power to accumulate in this inflationary period of sharply progressive income taxes depends in good measure upon the organization of one's business affairs so as to minimize the impact of income taxes. In many cases, therefore, in order to have the estate upon which to apply estate planning techniques, it is necessary first to minimize income taxes. In the majority of cases the vehicle that drives the client to the lawyer's office is an income tax horse pulling an estate tax cart. If taxes are a paramount consideration in the client's affairs, it is submitted that it is obviously wrong to put the cart before the horse.

54. See *Claire Giannini Hoffman*, 2 T.C. 1160 (1943).

55. See *Estate of Anna D. Childs*, 2 T.C.M. 388 (1943), rev'd o.g. 147 F. 2d 368 (3d Cir. 1945); *Edith M. Bense*, 36 B.T.A. 246, aff'd 100 F. 2d 639 (3d Cir. 1938).

56. See *Estate of James H. Matthews*, 3 T.C. 525 (1944).

57. See *Estate of John Q. Strange*, B.T.A. Memo. Op., C.C.H. Dec. 12516-D, April 29, 1942.